2011

Government Ethics and Bailouts: The Past, Present, and Future

Nicole Elsasser Watson

Foreword

Government Ethics and Bailouts: The Past, Present, and Future

Nicole Elsasser Watson*

In 2008, the United States experienced a catastrophic financial crisis—and, some might say, a financial panic—to a scale trumped only by the Great Depression.[1] The federal government responded by passing the Emergency Economic Stabilization Act of 2008[2] that created the Troubled Asset Relief Program (TARP),[3] bailing out several of the country's largest financial services companies. These responsive efforts were paradoxically rebuked as an inappropriate use of taxpayer dollars and hailed as curbing the tailspin of our financial system and economy.[4] The government's efforts to resolve the lingering and devastating effects of the 2008 financial crisis, however, did not end with the bailout. In the wake of public outrage—fueled by reports of bailed-out Wall Street companies paying

---

* Symposium Articles Editor, Volume 95, *Minnesota Law Review*. I humbly offer my sincere gratitude to Volume 95 Editor-in-Chief Reed Schuster, Dean David Wippman, and Professors Prentiss Cox, Claire Hill, Brett McDonnell, and Richard Painter for all of their contributions and efforts toward making the 2010 Symposium a dynamic success. In addition, I salute the entire Board and Staff of the *Law Review* for making the Symposium and publication of these articles possible. Finally, I extend my thanks to Stephen, for his unwavering encouragement and refractive perspective.

1. *See* Jon Hilsenrath et al., *Worst Crisis Since '30s, with No End Yet in Sight*, WALL ST. J., Sept. 18, 2008, at A1, *available at* http://online.wsj.com/article/SB122169431617549947.html.

2. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765.

3. *Id.* § 101(a)(1).

4. *Compare* Gretchen Morgenson, *A.I.G.'s Bailout Priorities Are in Critics' Cross Hairs: Covering Foreign Institutions Further Upsets Some in U.S.*, N.Y. TIMES, Mar. 18, 2009, at B1, *available at* 2009 WLNR 5102057 (reporting critiques of the government's generosity to financial institutions vis-à-vis taxpayers), *with* Peter S. Goodman, *But Will It All Work?*, N.Y. TIMES, Sept. 21, 2008, at A1, *available at* 2008 WLNR 17941937 (describing the bailout as a rescue effort).

their executives lavish bonuses at a time when the American public was being smothered by joblessness[5]—Congress passed the American Recovery and Reinvestment Act of 2009,[6] imposing restrictive rules on TARP recipients, and the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)[7] in 2010. Spanning over 2300 pages, Dodd-Frank is an extensive piece of legislation that tackles issues ranging from executive compensation to shareholder access and beyond. Still, as 2010 rolled on, economists warned that economic recovery in the United States was losing steam and that a double-dip recession was on our horizon.[8] Public angst over mounting national debt and waning economic recovery spurred the Obama Administration to announce a two-year civilian federal employee pay freeze in late 2010,[9] and a partisan impasse in budget negotiations threatened a federal government shutdown in 2011.[10] Thus, despite unprecedented legal responses to questions about our economic stability and ethical obligations in the face of crisis, these issues continue to plague our present and will remain relevant in the future.

The 2010 Government Ethics and Bailouts Symposium sought to bring together internationally renowned speakers, leading scholars, and esteemed civil servants to discuss the most apropos topics at the intersection of ethics and bailouts. Specifically, the Symposium deliberated (1) the question of whether capitalism failed, (2) ethical considerations revolving around government bailouts, and (3) long-term ramifications of government bailouts. Panelists were selected by the *Law Review* Staff with thoughtful input from our distinguished and

5. *See* Edmund L. Andrews & Peter Baker, *At A.I.G., Huge Bonuses After $170 Billion Bailout*, N.Y. TIMES, Mar. 15, 2009, at A1, *available at* 2009 WLNR 4926991; Peter S. Goodman, *Economists Scan Jobs Data, Seeking Signs of Hope*, N.Y. TIMES, Nov. 7, 2009, at B1, *available at* 2009 WLNR 22302516.

6. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115.

7. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

8. *See* Erin Ailworth, *Economy Slows; A 2d Slump is Feared: Fed Chairman Vows a Vigorous Response*, BOS. GLOBE, Aug. 28, 2010, at 1, *available at* 2010 WLNR 17144768; Jeff Sommer, *Double Dip? A Tipping Point May Be Near*, N.Y. TIMES, Aug. 15, 2010, at BU4, *available at* 2010 WLNR 16235864.

9. *See* Peter Baker & Jackie Calmes, *Obama Declares Two-Year Freeze on Federal Pay*, N.Y. TIMES, Nov. 30, 2010, at A1, *available at* 2010 WLNR 23765163.

10. *See* Carl Hulse, *Budget Impasse Increasing Risk of U.S. Shutdown*, N.Y. TIMES, Mar. 26, 2011, at A1, *available at* 2011 WLNR 5895283.

ever-supportive faculty. Each panel was designed to demonstrate diversity of ideas, expertise, and geography. After months of preparation, the Symposium included a vibrant pre-Symposium address by former Vice President Walter F. Mondale, an insightful cornerstone keynote address by Commissioner Troy A. Paredes of the U.S. Securities and Exchange Commission (SEC), and three distinguished panels: The Past: Did Capitalism Fail?, The Present: The Ethics of Government Bailouts of Private Industry in a Free Market System, and The Future: Long-Term Ramifications of Government Bailouts.

Former Vice President Mondale provided a pre-Symposium welcoming address to panelists, faculty, members of the *Law Review* Board and Staff, and other distinguished guests. Vice President Mondale noted that the 2008 financial crisis and ensuing government response highlighted the critical importance of ethics and transparency in government on both sides of the political aisle.

In the Symposium's keynote address, SEC Commissioner Paredes engaged panelists and attendees, underscoring the SEC's formidable regulatory task of deciding what to permit, prohibit, and mandate during this historic time. The Commissioner posited that an important bottom line question coming out of the financial crisis is: What makes an effective board of directors and, more specifically, what makes an effective independent director? Symposium panelists, employing various approaches and making distinct conclusions, further called attention to regulatory and practical questions coming out of the financial crisis.

The Past: Did Capitalism Fail?, the Symposium's first panel, inspired by Judge Richard Posner's *A Failure of Capitalism: The Crisis of '08 and the Descent into Depression*,[11] challenged panelists to unpack lingering questions about capitalism in light of the financial crisis. Professor William Black of the University of Missouri-Kansas City School of Law boldly accepted that challenge and concluded that capitalism is criminogenic and that its supporting theoclassical economics dogma failed. Black defined criminogenic environments as those that create strong, perverse incentives to act criminally and addressed why finance is particularly vulnerable to, and has become increasingly, criminogenic. Black suggested examples of capitalism's criminal incentives include executive and professional compen-

11. RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION (2009).

sation as well as an ideological hostility toward regulation. Furthermore, Black insisted that theoclassical economics failed in that it ignored economic fraud theories, such as lemons and moral hazard.

Professor Jeffrey Lipshaw of the Suffolk University Law School answered the question of whether capitalism failed differently—he chose to probe the syntax and semantics of the question itself. Rather than assessing the merits of modern global financial systems, Lipshaw assessed how those without financial expertise make sense of catastrophes like the financial crisis. Concluding that capitalism didn't fail, but the metaphors got a "C," Lipshaw posited that the verb construction of the question "did capitalism fail?" is ambiguous and leads to differing explanatory metaphors about cause and effect in the financial crisis. Lipshaw, in turn, challenged those metaphors.

Former SEC Commissioner Paul Atkins began our second panel, The Present: The Ethics of Government Bailouts of Private Industry in a Free Market System. Atkins highlighted the benefits of hindsight in the financial crisis and advocated for transparency as a fundamental regulatory principle. Jonathan Katz, former SEC Secretary, analyzed who really benefitted from the bailout. Katz tracked the government's actions during the financial crisis, beginning with the collapse of Bear Stearns, and then assessed governmental interventions through both TARP and non-TARP funding. Katz argued that TARP was merely one component of a much larger governmental intervention remarkably similar to governmental responses to past banking failures. Noting fundamental changes in the banking business model and significant industry consolidation, Katz predicted that future bank failures are inevitable. Concluding that some discrete creditors and banks on the verge of failure benefited from the bailout, Katz expressed doubt about whether the bailout addressed underlying and reoccurring problems in our nation's financial system. While acknowledging that Dodd-Frank provides regulators with greatly expanded authority, Katz cautioned that it remains uncertain how this power will be used.

Professor Kathleen Clark of Washington University in St. Louis School of Law unpacked what the U.S. Department of the Treasury got right and wrong in TARP, specifically with respect to fiduciary-based standards for bailout contractors. Clark acknowledged the government's legitimate reasons for outsourcing some services to contractors, including its reliance on contractors in connection with the bailout, but suggested that the government's decision to impose fiduciary-based ethics restrictions on outsiders implementing TARP was unusual and may have been unwise in some respects. Specifically, Clark cautioned that the costs involved in implementing an expanded financial disclosure regime and the First Amendment concerns raised by an imposition of prepublication review should be examined more closely before the government expands these approaches to protecting the public trust.

Taking a different approach, Professors Claire Hill and Richard Painter of the University of Minnesota Law School focused their analysis on how conflicts of interest erode personal responsibility in government and banking. Hill and Painter asserted that government involvement in business as regulator—and sometimes manager—is an inevitable reality, but imported that conflicts of interest is one critical reason why government might perform these functions poorly. Hill and Painter highlighted how some conflicts of interest are particularly difficult to regulate, such as when a government or corporate official seeks to advance interests incongruent with those he or she is supposed to be advancing. Beyond promoting an ethos of personal and professional responsibility of business and government decisionmakers, Hill and Painter further suggested that imposing some degree of personal liability in the business sphere and commensurate measures of accountability in government may be an important step toward greater responsibility. Hill and Painter also opined that strengthening alternative voices in the decisionmaking process, reducing decisionmakers' exposure to the most potent sources of conflicting interest, and increasing transparency in both business and government should help shore up these problems.

Finally, in our third panel, The Future: Long-Term Ramifications of Government Bailouts, Professor Lisa Fairfax of George Washington University Law School reconciled government bailouts, corporate governance, and directors' fiduciary duties. Specifically, Fairfax discussed how the wave of governmental reforms following the financial crisis intruded on board functions and responsibilities, dramatically enhancing board duties. Fairfax cautioned that reforms failed to fully address the limitations associated with board functions and fiduciary duties, thus hampering the board's ability to effectively fulfill those tasks without creating an effective mechanism for ensuring that boards are held accountable for failing to perform their new tasks. While convinced that a more robust discussion of boards and their role in the modern corporation is necessary, Fairfax was skeptical about the federal government's ability to fully engage in such a discussion.

Professor Steven Davidoff of the University of Connecticut School of Law focused his analysis on the terms and experience of the federal government's private ownership during the financial crisis. Davidoff posited that potential losses on the government's corporate investments—both in the aggregate and individually—pale in comparison to the avoided costs of a more significant economic downturn and financial panic. Still, Davidoff critiqued the government's failure to negotiate financial and governance structures that were in its best interest, such as legal, economic, and time limitations. Anticipating future, though rare, instances of government corporate ownership, Davidoff presented principles to guide the structure, monitoring, and retention of government investment in private enterprise.

Professor Stephen Bainbridge of the UCLA School of Law criticized the government's enactment of Dodd-Frank. In parlance coined by Roberta Romano,[12] Bainbridge argued that Dodd-Frank's six key corporate governance provisions represent "quack federal corporate governance." Specifically, Bainbridge asserted that Dodd-Frank lacks strong empirical or theoretical justification and was enacted via a hijacked legislative process aimed at achieving policy goals essentially unrelated to the causes or consequences of the financial crisis. Bainbridge discussed how Dodd-Frank's corporate governance provisions erode the system of competitive federalism—the unique genius of American corporate law—by displacing state regulation with federal law. Bainbridge concluded that Dodd-Frank represents the continued federalization of corporate governance that has become a default response whenever the federal government is moved to action by a new economic crisis.

Although unable to attend the Symposium, Professor Usha Rodrigues of the University of Georgia School of Law similarly argued in her contribution to this issue that Dodd-Frank reforms are flawed and misguided. Rodrigues noted that ideally, long-term investors—with the motivation to watch closely—should monitor public corporations, but too often investors instead respond to short-term incentives. Rodrigues further discussed how regulatory responses to the bailout utilized long-

12. Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005).

term investor tools like shareholder empowerment, disclosure, and independence, without acknowledging that rational shareholders often focus on diversification of their assets, which negates incentives to use shareholder empowerment tools. Instead, Rodrigues proposed carefully chosen forms of substantive governmental regulation or restructuring the law to realign the incentives of institutional investors with those of long-term shareholders.

The articles contained in this issue demonstrate the panelists' attempt to address concerns that cut across multiple areas of financial crises and regulation: capitalism, ethics, and long-term ramifications of government bailouts. It is the *Minnesota Law Review*'s desire that this symposium discussion will fuel evolution of the law in the government ethics and bailouts context.